Nos. 87-453 and 87-464

In the Supreme Court of the United States

OCTOBER TERM, 1987

AMERADA HESS CORPORATION, ET AL.,
APPELLANTS,

v.

DIRECTOR, DIVISION OF TAXATION,
APPELLEE.

TEXACO INC. AND TENNECO OIL COMPANY,
APPELLANTS,

v.

DIRECTOR, DIVISION OF TAXATION,
NEW JERSEY DEPARTMENT OF THE TREASURY,
APPELLEE.

ON APPEAL FROM THE SUPREME COURT OF NEW JERSEY

Brief of the Committee on State Taxation of the Council of State Chambers of Commerce, the National Association of Manufacturers and the Chamber of Commerce of the United States as Amici Curiae in Support of Jurisdictional Statements of Appellants

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Table of Contents

Table of Authorities Cited

Cases

Statutes

Miscellaneous

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Introductory Statement

This brief is submitted by the Committee on State Taxation of the Council of State Chambers of Commerce, the National Association of Manufacturers and the Chamber of Commerce of the United States of America as *amici curiae* in support of the jurisdictional statements filed by appellants in the above-captioned cases. Written consents of the appellants and the appellee have been obtained and filed with the Clerk of the Court.

Interest of Amici Curiae

The Council of State Chambers of Commerce ("COUNCIL"), organized in 1932, consists of 42 Chambers of Commerce. The Committee on State Taxation ("COST"), one of the three advisory committees of the COUNCIL, consists of 262 corporate members which conduct a substantial portion of the interstate commerce of United States taxpayers. One of COST's principal activities has been to work with the states and others toward developing fair and equitable standards of state taxation.

The National Association of Manufacturers of the United States of America ("NAM") is a non-profit, voluntary business association incorporated under the laws of the State of New York. The NAM represents more than 13,000 companies, large and small, located in every state. Further, NAM is affiliated with an additional 158,000 businesses through the Associations Council and the National Industrial Council. The membership of the NAM represents an estimated 80 percent of all goods manufactured in the United States.

The Chamber of Commerce of the United States ("Chamber") is the largest federation of business organizations and individuals in the United States. Current Chamber membership includes more than 180,000 corporations, partnerships and proprietorships, as well as several thousand trade associations and state and local chambers of commerce. The Chamber regularly advocates its members' views in court on issues of national concern to the American business community.

Member companies of COST, NAM and the Chamber are representative of that part of the nation's business sector which is most directly affected by state taxation of interstate operations. These members include most of the appellants and other oil companies, as well as companies engaged in a diverse range of manufacturing, retailing and financial pursuits.

COST, NAM and the Chamber are, therefore, vitally interested in cases such as this one which present issues significantly affecting state taxation of interstate commerce.

Summary of Argument

This case challenges New Jersey's novel approach to an old dilemma: how to increase state revenues without burdening local taxpayers. New Jersey's approach is to define the net income of multistate businesses so as to disallow the deduction of a particular expense which *cannot* be incurred in New Jersey, the expense of the windfall profit tax. This "definition" violates the Due Process, Commerce and Equal Protection Clauses because it singles out out-of-state activities for disfavored treatment and results in a disproportionate allocation of taxpayers' apportionable income to the taxing state. More importantly, this case warrants plenary review because the New Jersey approach establishes a model which any state seeking to impose a disproportionate share of its tax burden on value earned elsewhere may seek to emulate.

Argument

I. This Case Warrants Plenary Review.

Faced with the ubiquitous pressures to increase state revenues while not incurring the wrath of local voters and taxpayers, states have often yielded to the temptation to impose a disproportionate share of their tax burden on out-of-state activities. *See, e.g., American Trucking Ass'n's, Inc.* v.

Scheiner, 107 S. Ct. 2829 (1987); *Westinghouse Electric Corp.* v. *Tully*, 466 U.S. 388 (1984); *Austin* v. *New Hampshire*, 420 U.S. 656 (1975); *Hans Rees' Sons, Inc.* v. *North Carolina*, 283 U.S. 123 (1931); *Travis* v. *Yale & Towne Mfg. Co.*, 252 U.S. 60 (1920).

States have taken a number of different approaches in their attempts to tax extraterritorial values: New York allowed personal exemptions from the state income tax on residents' returns only, *Travis, supra* at 79; North Carolina adopted an apportionment formula which imposed a tax burden on interstate businesses vastly out of proportion to their activities in North Carolina, *Hans Rees' Sons, supra* at 135-36; New Hampshire imposed an income tax on only those people who worked in New Hampshire but lived (and voted) elsewhere, *Austin, supra* at 659; New York disallowed certain tax credits in a manner which discriminated against business operations in other states, *Westinghouse, supra* at 400; and Pennsylvania imposed a flat tax on all trucks which, while facially neutral, had the effect of subjecting interstate vehicles to higher average taxation per mile than Pennsylvania vehicles, *American Trucking, supra* at 2844, 2847. In each of these cases and numerous others, this Court has rejected state efforts to tax a disproportionate or discriminatory share of out-of-state revenues.

The New Jersey tax in dispute here represents a novel means towards the same unlawful end. The New Jersey Corporation Business Tax ("CBT"), N.J. Stat. Ann. § 54:10A-1 *et seq.* (West 1986), acts as a tax on extraterritorial value through the state's definition of "entire net income" subject to apportionment. For purposes of determining the tax owed by a unitary, multistate business, New Jersey uses a seemingly-orthodox formula apportionment method which can be illustrated as follows:

"entire net income" subject to apportionment	×	3-factor apportionment formula	=	New Jersey taxable income.

N.J. Stat. Ann. § 54.10A-6 (West 1986).

The twist comes in the definition of "entire net income" subject to apportionment: New Jersey adopts the definition of entire net income from the federal return, meaning that, in general, business expenses allowable for federal tax purposes are allowable for determining the entire net income subject to apportionment. N.J. Stat. Ann. § 54.10A-4(k) (West 1986). Strikingly, however, a taxpayer may not deduct the expense of the crude oil windfall profit tax of 1980, 26 U.S.C. § 4986 *et seq.*[1] The CBT thus disallows an indisputably legitimate business expense, which, *by virtue of geological fact*,[2] can arise only in connection with out-of-state activity. By defining "entire net income" subject to apportionment to include the expense of the windfall profit tax, New Jersey has found a new source of revenue through the taxation of an expense which *cannot* arise in connection with in-state activity by virtue of the undisputed fact that there is no crude oil production in

[1] For the sake of simplicity, windfall profit tax expenses are referred to herein as a "deduction" in the sense that, for federal income tax purposes, they are subtractable from either gross receipts or gross income. Technically speaking, the windfall profit tax is generally treated as an inventoriable cost under I.R.C. § 471, meaning it is subtracted from gross receipts in computing gross income, rather than deducted from gross income in computing taxable income. There are also circumstances in which the windfall profit tax may be reclassified and deducted from gross income as an "ordinary and necessary" business expense under I.R.C. § 162 or as a tax under I.R.C. § 164. Regardless of whether the taxpayer treats the tax as an inventoriable cost, a business expense or a tax, however, the net effect on the calculation of taxable income is the same.

[2] New Jersey has no proven reserves of crude oil, and, consequently, no production of crude petroleum. U.S. Department of Commerce, *State and Metropolitan Area Data Book* 585 (1986).

New Jersey. Thus, the plain effect of this "definition" of entire net income is to disallow the deduction of a particular expense which can arise only outside of New Jersey, thereby increasing state revenues without placing any increased burden on local activities.[3]

The beauty of New Jersey's method — from the perspective of the state tax collector — is its appearance of being squarely within the bounds of allowable state discretion. It is now understood that a state is entitled to tax its fairly-apportioned share of the entire net income of a multistate, unitary business, wherever that income was earned. *Exxon Corp.* v. *Dep't of Revenue*, 447 U.S. 207, 219 (1980). New Jersey thus maintains that it is merely exercising its discretion to *define* entire net income as it sees fit, and that, so long as it is merely exercising that discretion, it is entitled to discriminate unabashedly against out-of-state activity.

Through the "definition" of entire net income subject to apportionment, New Jersey has seemingly discovered the solution to the age-old dilemma of how to increase state revenues without burdening local business: by excluding the allowance of a deduction that, of necessity, can arise only from out-of-state activity,[4] New Jersey will raise an approximately $98 million in taxes[5] without increasing the tax burden on in-state activity by one penny.

[3] Unlike Minnesota and Wisconsin, whose tax codes contain explicit provisions disallowing deduction of the windfall profit tax, *see* Appendix G to Jurisdictional Statement filed by Amerada Hess Corporation appellants, New Jersey's disallowance was effectuated through a ruling of the state's highest court which determined, as a matter of state law, that the windfall profit tax is a tax on "profits or income" and, as such, not deductible as a matter of state law. Needless to say, for purposes of constitutional analysis, state law as set forth by the state's highest court is as subject to challenge as would be an identical law enacted by the legislature.

[4] *See* n.2, *supra*.

[5] *New Jersey Budget Message and Taxpayers' Guide, Fiscal Year 1987-1988*, at 11 (Feb. 2, 1987).

The issue presented on this appeal is by no means limited to the State of New Jersey or the windfall profit tax. All state legislatures are subject to the same pressures to increase services without increasing taxes on local business and local voters. If New Jersey can increase its revenues without burdening local activity by the simple expedient of redefining the meaning of "entire net income," each of her sister states can attempt to follow suit. Any observant state legislator can note which activities conducted by multistate businesses are not conducted in-state, and propose a revision of the state tax code which would disallow deductions in connection with those activities.

The most obvious targets of the New Jersey-type approach are severance taxes. Severance taxes, like the windfall profit tax, are a substantial cost of doing business for companies engaged in the mining or development of natural resources. Following New Jersey's lead, it would be an easy matter for states lacking in natural resources to add a line to their tax codes providing that businesses shall calculate their entire net income subject to apportionment without deducting severance taxes. For example, New Hampshire, which was recently rebuffed in its efforts to impose an income tax on non-residents only, *Austin* v. *New Hampshire*, 420 U.S. 656 (1975), has no crude oil reserves.[6] All petroleum products sold in New Hampshire must be manufactured from crude oil from other states. By precluding multistate businesses from recognizing petroleum severance taxes as a business expense, New Hampshire could attempt to raise its revenues without imposing any additional taxes on New Hampshire residents, thus accomplishing through a different means the very goal sought by the "commuter tax" struck down in *Austin*. As a matter of geological fact, the incidence of such a revision in the tax code would necessarily fall on business activity outside of New Hampshire.

[6] U.S. Department of Commerce, *State and Metropolitan Area Data Book* 585 (1986).

The New Jersey approach presents similar possibilities for tax code manipulation with respect to virtually any natural resource. Coal-producing companies, for example, pay to the United States Treasury $1.10 per ton of underground coal mined for the black lung disability trust fund excise tax, I.R.C. § 4121. If the states were free to refuse to recognize coal excise taxes as deductible business expenses, just as New Jersey has refused to recognize the windfall profit tax as a deductible expense, they would, in effect, be permitted to assess a tax on $1.10 per ton of coal that was never actually earned. Whatever constitutional leeway the states may have, as an abstract matter, to define allowable business deductions, a "definition" which would exclude coal excise taxes must be a legitimate subject of constitutional scrutiny when promulgated by states which, as a matter of well-known and documented fact, have no coal. The Court is not compelled to close its eyes and assume that a state must have had *some* non-discriminatory rationale for defining income in a manner that patently discriminates against out-of-state businesses; to the contrary, a "tailored" tax is to receive the "careful scrutiny of the courts to determine whether it produces a forbidden effect on interstate commerce," because a tailored tax "creates an increased danger of error in apportionment, of discrimination against interstate commerce, and of a lack of relationship to the services provided by the State." *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 288-89 n.15 (1977).

Nor are the risks of the New Jersey approach presented only to companies that pay natural resource extraction taxes. Any readily-observable difference between the states can offer the tax code drafter a similar opportunity. For example, local businesses located in landlocked states have no occasion to pay the harbor maintenance trust fund excise tax, I.R.C. § 4461, which is assessed as a percent of the value of commercial cargo loaded or unloaded at United States ports. Under New Jersey's approach, such states may perceive themselves as being at liberty to direct multistate businesses to "add back" harbor maintenance taxes when calculating net income subject to apportionment.

Moreover, if New Jersey is free to preclude multistate businesses from recognizing tax payments as deductions from net income on a geographically disproportionate basis, then states may argue that it is equally permissible for a state to single out any deduction, however disproportionate its incidence, and preclude taxpayers from deducting that expense from the calculation of income. This possibility opens a whole range of opportunities for geographic discrimination and extraterritorial taxation.

To take a few examples, local businesses in states with little heavy industry incur few expenses for pollution controls. If such states were permitted to disallow from the calculation of net income all expenses in connection with pollution abatement, the necessary result would be to increase taxable income of multistate businesses while barely affecting the tax burdens on local industry.[7] Similarly, states which contain no facilities for the manufacture of automobiles may seek to disallow expenses related to automobile manufacture, with full confidence that the increased revenues would come entirely from business operations elsewhere.

The danger of the New Jersey-type of geographic discrimination affects not only individual taxpayers but, more importantly, the federal system as a whole, because it encourages endless rounds of retaliation between the states, as taxpayers who feel unfairly burdened by geographically-tailored defini-

[7] By way of comparison, pollution abatement capital expenditures by manufacturers in 1983 were less than $2 million in states such as Hawaii, New Hampshire and Wyoming, compared to over $90 million in the same year in the heavily-industrialized states of Ohio and Pennsylvania. U.S. Department of Commerce, *State and Metropolitan Area Data Book* 549 (1986).

tions of income encourage their home states to respond in turn by disallowing deductions which are incurred in the offending states:

> Since nonresidents are not represented in the taxing State's legislative halls, . . . judicial acquiescence in taxation schemes that burden them particularly would remit them to such redress as they could secure through their own State; but 'to prevent [retaliation] was one of the chief ends sought to be accomplished by the adoption of the Constitution.'

Austin v. *New Hampshire*, 420 U.S. 656, 662 (1975), *quoting Travis* v. *Yale & Towne Mfg. Co.*, 252 U.S. 60, 82 (1920).

Thus, for example, if there is no constitutional barrier to New York, which has no coal production,[8] defining net income such that coal severance taxes are not deductible, then the coal-producing companies would have no recourse but to turn to their home legislatures and request the disallowance of tax expenses which are peculiarly incidental to New York, such as stock transfer taxes.[9]

The above-described scenarios are not merely hypothetical. Six states in addition to New Jersey have already disallowed deductions for the windfall profit tax. With the exception of a negligible amount of oil production in New York, none of those states produce any crude oil. *See* authorities cited in Jurisdictional Statement filed by Amerada Hess Corporation appellants at 14-15.

In sum, the issue of constitutional limitations on state power to define taxable income warrants plenary review. A definitive resolution of the question whether it is permissible for a state to define income in a geographically tailored manner is essential in order to avoid the chaos described above.

[8] U.S. Department of Commerce, *State and Metropolitan Area Data Book* 585 (1986).

[9] Aside from New York, only two states impose stock transfer taxes. J. Hellerstein, *State Taxation* 20-21 (1983). For New York, stock transfer taxes have "long been a source of substantial revenue." *Id.* at 145. The New York stock transfer tax, N.Y. Tax Law § 270 (McKinney 1986), is imposed, *inter alia*, on all sales of securities occurring within New York State, which necessarily includes all sales on the New York Stock Exchange. *Cf. Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. 318 (1977).

II. New Jersey's Definition of Net Income Subject to Apportionment Violates the Due Process, Commerce and Equal Protection Clauses.

A. *Through Its Definition of Net Income, New Jersey Has Attributed to Itself a Disproportionate Share of the Taxpayers' Net Income in Violation of the Due Process Clause.*

A state may not, consistent with the Due Process Clause, tax value earned outside its borders. *Container Corp. of America* v. *Franchise Tax Board*, 463 U.S. 159, 164 (1983). The constitutionality of the unitary business/formula apportionment method is based on the premise that it results in each state taxing only that portion of net income which is reasonably attributable to the business conducted in that state. *Butler Bros.* v. *McColgan*, 315 U.S. 501, 506 (1942). That premise is violated by the New Jersey approach.

By defining net income subject to apportionment such that deductions arising from exclusively out-of-state activity are disallowed, while ordinary business deductions arising from in-state activity are allowed, New Jersey has effectively attributed to itself a disproportionate share of the multistate taxpayers' income. A state can no more be free to discriminate

in its definition of net income subject to apportionment than it is to use a biased apportionment formula: since the net income figure is multiplied by the apportionment formula, both calculations must be subject to the same constitutional restraints. Otherwise, the state could simply accomplish through its definition of net income what it is barred from effecting through its apportionment formula.

What New Jersey is arguing for here is not, as it asserts, the right to apportion 100% of a unitary business's net income. That right is not being challenged. To the contrary, New Jersey is seeking the unfettered right to define net income in any way it sees fit — regardless of whether its definition taxes extraterritorial values or discriminates against out-of-state activity.

The New Jersey approach cannot be saved by its facial neutrality. Simply because New Jersey purports to disallow deductions for "all" federal income or profits taxes does not mean that it can shield the actual effect of its law from judicial scrutiny. This Court has rejected "formalism[s] [which] 'merely obscure the question whether the tax produces a forbidden effect.'" *American Trucking, supra* at 2846, *quoting Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 288 (1977). *See also Maryland* v. *Louisiana*, 451 U.S. 725, 756 (1981) ("A state tax must be assessed in light of its actual effect"). In *American Trucking*, Pennsylvania sought to uphold its flat taxes on trucks on the grounds that all vehicles, both in-state and interstate, paid the same flat tax. This Court had little difficulty rejecting that contention, noting that, "in practical effect," the tax imposed a greater cost per mile on interstate than on local carriers. *Id.* at 2841. Here, the practical effect of New Jersey's interpretation of its CBT is clear and undisputed regardless of its appearance of neutrality: there is no oil production in New Jersey and hence New Jersey's interpretation of "entire net income" imposes additional taxes on exclusively out-of-state activities, thus appropriating to New Jersey values which are beyond its constitutional authority to tax.

B. *New Jersey's Discriminatory Taxation Threatens the "Free Trade Zone" Created by the Commerce Clause.*

The central purpose of the Commerce Clause was "to create an area of free trade among the several States," *Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. 318, 328 (1977). Within the "national free trade area," state boundaries are to be "economically irrelevant." *American Trucking, supra* at 2840-41. New Jersey's method of discriminatory taxation threatens the existence of the national free trade zone.

New Jersey's approach to enhancing state revenues at the sole expense of out-of-state activity can — and inevitably will — be viewed as a model by other states. Allowing each state to disfavor activities which are necessarily or predominantly performed elsewhere threatens the federal system. For example, states without natural resources may disallow severance taxes, and the resource-rich states may retaliate by disallowing the business expenses of high technology industry. This type of retaliation could continue *ad infinitum* until the national free trade zone has become a balkanized confederacy of retaliatory tax regions. The Commerce Clause does not allow the states to exercise such powers: "[T]axing or regulatory structures threatening to balkanize the national economy should be imposed, if at all, only by Congress, and not by an entity with less than a nationwide constituency." L. Tribe, *American Constitutional Law* 361 (1978).

Thus, it is no answer for the Supreme Court of New Jersey to assert that this law does not offend the Commerce Clause because, whatever the discriminatory effect on out-of-state industry, there are no local crude oil producers to be favored.[10]

[10] The Court below stated: "Denial of the W.P.T. deduction does not violate the commerce clause because it does not favor in-state over out-of-state economic activity." Appendix A to Jurisdictional Statement of Amerada Hess Corporation appellants at 34a.

This argument presupposes that the Commerce Clause was meant to be no more than an equal rights act as between local and interstate industries. When one recognizes the actual purpose of the Commerce Clause — the creation of a national free trade zone — the absence of affected local producers is properly seen as irrelevant. Indeed, under New Jersey's restrictive reading of the Constitution, its state tax code could explicitly deny deductions for all business expenses incurred in specifically-designated sister states.

More importantly, the New Jersey system, by focusing its taxation burdens on out-of-state activity, implicates the fundamental principle that there shall be no taxation without representation:

> Despite mechanical or artificial distinctions sometimes taken between the taxes deemed permissible and those condemned, . . . [l]ying back of these decisions is the recognized danger that, to the extent that the burden falls on economic interests without the state, it is not likely to be alleviated by those political restraints which are normally exerted on legislation where it affects adversely interests within the state.

McGoldrick v. *Berwind-White Coal Mining Co.*, 309 U.S. 33, 45-46 n.2 (1940). The absence of favored local interests is simply not pertinent to the suspect nature of state regulation which "imposes special or distinct burdens on out-of-state interests unrepresented in the state's political process." *American Constitutional Law, supra* at 326.

C. *New Jersey's Parochial Discrimination Against Out-of-State Interests Violates the Equal Protection Clause.*

The Equal Protection Clause "forbids a State to discriminate in favor of its own residents solely by burdening 'the residents of other state members of our federation.'" *Metropolitan Life Ins. Co.* v. *Ward,* 470 U.S. 869, 878 (1985), *quoting Allied Stores of Ohio, Inc.* v. *Bowers,* 358 U.S. 522, 533 (1959). In *Metropolitan Life,* this Court held that the provisions of Alabama's tax code which imposed a higher rate of tax on foreign than on domestic insurance companies violated the Equal Protection Clause on the grounds that "Alabama's purpose . . . constitutes the very sort of parochial discrimination that the Equal Protection Clause was intended to prevent." *Id.* at 878.

The New Jersey law at issue here exemplifies the same type of "parochial discrimination" as that struck down in *Metropolitan Life.* New Jersey is favoring its own residents by imposing burdens on out-of-state activity which will not be shouldered by local taxpayers. Because New Jersey refuses to allow the deduction of indisputably legitimate business expenses which arise only out-of-state, the plain result of the taxation scheme is that certain multistate businesses are subjected to higher rates of taxation than New Jersey businesses.

"[A] state may not constitutionally favor its own residents by taxing foreign corporations at a higher rate." *Id. See also WHYY, Inc.* v. *Glassboro,* 393 U.S. 117, 120 (1968) (provision of New Jersey's property tax struck down as violative of the Equal Protection Clause because "New Jersey has denied the appellant a tax exemption which it accords other nonprofit corporations solely because of the appellant's foreign incorporation"); *Williams* v. *Vermont,* 472 U.S. 14 (1985) (Vermont provision allowing only residents to be credited for certain sales taxes gives rise to claim under Equal Protection Clause);

Gilbert Associates, Inc. v. *Commonwealth*, 498 Pa. 514, 447 A.2d 944 (1982) (Pennsylvania law which allowed domestic corporations to select apportionment formula, while prescribing particular apportionment formula for foreign corporations, held to violate both federal and state constitutions).

Refusing to allow a deduction has precisely the same impact as raising the rate of taxation. New Jersey's attempt to favor its constituents by imposing higher tax burdens on out-of-state interests should be struck down under the Equal Protection Clause.

Conclusion

Probable jurisdiction should be noted.

Respectfully submitted,

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